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TAGS: EFIN ECON HU
SUBJECT: (CORRECTED VERSION) 2009 GYURCSANY PLAN: A
POSITIVE STEP, BUT "NOT A WINNING PROGRAM"

¶1. (SBU) SUMMARY: Prime Minister Gyurcsany on February 16 presented to Parliament a package of proposed measures intended to plug a roughly $1 billion hole in this year's budget and stabilize Hungary's careening economy through incentives to increase employment and investment. The tax adjustments and budget savings contained in the program represent neither fiscal stimulus nor fiscal consolidation; apart from filling this year's budget gap, the measures are designed to be budget neutral. Proposals affecting businesses eliminate the "solidarity tax" and decrease welfare contributions, but widen the tax base and increase the tax rate, resulting in a negligible overall benefit. In addition to a number of positive, but modest, steps to rationalize Hungary's generous social welfare and pension systems, the proposal includes a hodge-podge of measures that the GoH has either already put in train or has no realistic hope of achieving during the remainder of its term. This new "Gyurcsany Plan" will almost certainly have a more salutary impact on Hungary's economy than did the Prime Minister's 2006 revenue-based austerity program, but most commentators agree that the measures are too little and too late to prevent a deep economic downturn in the near-term and, although they are steps in the right direction, they are not sufficient to place the Hungarian economy on a more sustainable and competitive footing over the longer term.
END SUMMARY.

ANOTHER "GYURCSANY PLAN"

¶2. (SBU) In a speech before Parliament on February 16, Prime Minister Gyurcsany formally unveiled a five-part package of proposed measures designed to prevent the 2009 budget from taking the Hungarian economy off course, potentially reversing the deficit reduction from 9.3 percent of GDP in 2006 to less than 3.5 percent in 2008. This new "Gyurcsany Plan" is also intended to lay a foundation for improving Hungary's investment climate and competitiveness. The proposed measures, however, clearly assign priority to near-term job preservation and creation, particularly at the lower end of the wage scale, and efforts to get Hungarians off the dole and back to work. They are not a comprehensive overhaul of Hungary's bloated social services sector. In a televised speech on February 17, Gyurcsany explained that the GoH is not concerned right now with deep institutional reforms such as health care and education, because these would lead to layoffs. (Comment: In reality, the Prime Minister probably also wants to avoid repeating the failure of his last attempt to initiate modest health sector reforms. End Comment.)

¶3. (U) Apart from some specific tax adjustments, spending cuts, and investment incentives, most of the program appears to be more of a wish list than a detailed course of action. We expect further details to emerge as the proposals are submitted for parliamentary debate in the coming weeks.

RESCUING THE 2009 BUDGET

¶4. (SBU) A number of the planned spending cuts appear directly aimed at filling a roughly $1 billion gap in the 2009 budget. The gap was created by the GoH's reinstatement last December of the "13th month wage," following the earlier removal of this benefit as part of Hungary's IMF/EU bailout last fall. In addition, forecasted budget revenues have recently been revised downward in light of the deteriorating Hungarian economy. Official forecasts now project a 3-3.5 percent GDP contraction this year, in contrast to a previously projected 0.9 percent contraction. Passage of these cost savings measures would allow the GoH to meet a revised deficit target of 2.9 percent of GDP, up from an earlier target of 2.6 percent. This is still below the 3 percent threshold for remaining in compliance with Hungary's euro-convergence plan and IMF requirements.

¶5. (U) The GoH expects to shore up its 2009 budget with the following:

($ millions)

Frozen ministry expense allocations	250
Reduced housing subsidies	30

Tightened disability pension eligibility	42
Decreased residential gas subsidies	83
Interest savings	100
Reduced prescription drug subsidies	125
Reduced agricultural subsidies	138
Tightened welfare benefit eligibility	25
Revenue from CO2 emission sales	83
TOTAL	876

A MORE EMPLOYMENT-FRIENDLY TAX REGIME?

¶6. (SBU) The first chapter of the new Gyurcsany plan focuses on establishing a more "work-friendly" tax regime. According to Peter David, CEO of the American Chamber of Commerce in Hungary, the proposed measures mark a step in the right direction--they generally accord with the recommendations the AmCham and the "Big Four" accounting firms made last year--but, in addition to the fact that they are several years too late, they "lack the magnitude" necessary to improve Hungarian competitiveness. The proposed tax cuts are entirely compensated by other tax hikes in 2009.

¶7. (SBU) The proposed tax cuts include a reduction of the employer's share of employment taxes from 32 percent to 27 percent, an important step toward lowering Hungary's "tax wedge," which is among the highest in Europe. This reduction would apply to lower wage earners beginning in July and to all wage earners from 2010. Hungary's largest trade union association has already registered its objection to the fact that the plan would cut taxes paid by employers rather than workers' contributions. A proposed personal income tax reduction, whereby a slight increase in tax rates--from 18/36 percent to 19/38 percent--is more than offset by an increase in the income taxed at the lower rate, also appears to aim at enticing job-seekers into the registered workforce. Elimination of the 4-percent "solidarity tax" on businesses is also a step in the right direction, but the draft plan offsets its positive effects by increasing corporate tax rates from 16 to 19 percent and widening the tax base through the elimination of most allowances. The tax plan would also eliminate the 4 percent "solidarity" surtax on high-income individuals.

¶8. (SBU) The GoH proposes to pay for these tax cuts by increasing taxes on consumption: the VAT would rise by 3 percentage points to 23 percent, as would excise duties on tobacco, alcohol and fuel by 3-7 percentage points. Most analysts question the value of raising taxes on consumption during a deep global recession. Along with decreasing domestic demand during a time when export markets are shrinking, a higher VAT would impose a greater burden on local governments and entities seeking to co-finance EU-funded projects. Local tax reform advocates, however, applaud the proposed elimination of various tax allowances, which will make the tax code simpler, more transparent, and more difficult to evade. A proposed tax levy on certain welfare benefits would recapture funds for the budget while also increasing the relative value of employment for those currently living on public support.

¶9. (U) The proposed tax modifications would have the following effects on the budget in 2009 and 2010:

($ millions)	2009	2010
Reduced employer contribution	(346)	(1,279)
Reduced personal income tax	(146)	(804)
Eliminated solidarity tax for individuals	(42)	(121)
Eliminated solidarity tax for businesses	0	(867)
Change in corporate income tax	0	708
Increased VAT	446	1,033
Increased excise taxes	67	167
Increased rehabilitation contribution	0	88
Tax on welfare benefits	0	896
Change in welfare benefits	21	125
TOTAL	0	(54)

TIGHTENING THE SOCIAL SAFETY NET

¶10. (SBU) The new plan's second and third chapters aim to rationalize, without overhauling, the social safety net by tightening eligibility for social benefits, enhancing incentives to work, and placing the pension system on a more sustainable footing. An already existing "welfare-to-work" program would be expanded and the concept applied to family allowances, which for families with older children would become education allowances subject to cancellation if the child leaves school. As with disability benefits, eligibility for child-rearing benefits would be tightened, while measures to promote daycare provision would make it easier for young parents to go back to work. The plan would also create by 2011 a "single social account" to allow authorities to track the aggregate level of support received by an individual to ensure that income from social support does not exceed that which could be earned through employment. Savings on pension costs would begin in 2010 with the elimination of the "13th month pension" and a change in the annual indexing formula that would base pension increases more closely on inflation and less on real wage growth. A proposed gradual increase in the retirement age from 62 to 65 between 2016 and 2024 would bolster the system's long-term sustainability.

ECONOMIC DEVELOPMENT AND ADMINISTRATIVE REFORM MEASURES: A SHOTGUN APPROACH

¶11. (SBU) The final two chapters of the plan focus on measures to promote business and infrastructure investment and to streamline the public sector. The laundry list of new and existing, short-term and long-term business development initiatives includes a variety of proposed energy and transport infrastructure investments, rural development, market support for Hungarian agricultural and food products, a near-term effort to attract foreign investment in low

value-added/high-employment sectors, and a longer-term effort to develop Hungary's knowledge-intensive industries. The GoH plans to step-up its commercial diplomacy with "countries less affected by the crisis," among which it includes Russia, and back these efforts with export promotion assistance and credit insurance for Hungarian businesses. A measure to promote employee retention would allow companies to use EU funding to place employees in job-related training one day per week. The package would roughly triple funding to support small and mid-sized businesses and start-ups to $5.8 billion through 2010, plus an additional $3.75 billion in government guarantees, through accelerated use of EU funds and previously-budgeted Hungarian co-financing.

¶12. (SBU) The plan presents a wish list of measures to streamline public administration, including reducing the size of Parliament to 199 members, cutting local government representation by 50 percent, reforming MPs' expense accounts, and a variety of measures to reduce the size and expense of Hungary's extensive bureaucracy. Many of these measures would require a two-thirds majority in Parliament to pass. (Comment: It is highly unlikely that these measures would be approved, given the current political climate. End comment.) The remaining proposals constitute a vague list of good intentions to cut red tape, improve bankruptcy protection, and reduce corruption. We anticipate further details on these in the coming weeks.

SECOND VERSE, SAME AS THE FIRST?

¶13. (SBU) Responses to the new Gyurcsany Plan so far have been fairly predictable. The IMF, the EU, and financial analysts have cautiously praised the measures as a step in the right direction, albeit one that probably should have been taken months or years ago. They also emphasize that further budget cuts and deeper institutional reforms will be necessary to place Hungary on a more sustainable long-term path. On the other hand, opposition leader Viktor Orban immediately lambasted the plan as not simply "yet another brutal austerity package," but a package of "hopelessness, resignation, and surrender." He offered few specifics on what Fidesz would propose as an alternative except to emphasize the need to cut taxes, but his reaction is a likely foreshadowing of public reaction, particularly as increased consumption taxes and decreased social benefits would indeed

pour salt on the wounds of Hungary's struggling households, potentially deepening an already severe recession. Speaking at an economic conference on February 19, Free Democrat (SzDSz) chairman Gabor Fodor described the new package as "too little, too late," arguing that budget balance should be achieved by spending cuts rather than by tax hikes. Eva Palosz, director of Kopint-Tarki research institute, supports the tax changes, but also emphasizes the need to cut spending. The tax and savings proposals are thus likely to undergo some changes as the Gyurcsany government negotiates with SzDSz and MDF for support for the plan; SzDSz has already vowed not to support any tax hikes.

¶14. (SBU) Comment: Speaking to business leaders earlier this week, Gyurcsany admitted that, from a political standpoint, this new package is "not a winning plan." It does not appear to be from a business standpoint, either. Given his already low level of popularity, he would have had little to lose--and the Hungarian economy much to gain--from a much more aggressive reform package. End Comment.
Foley